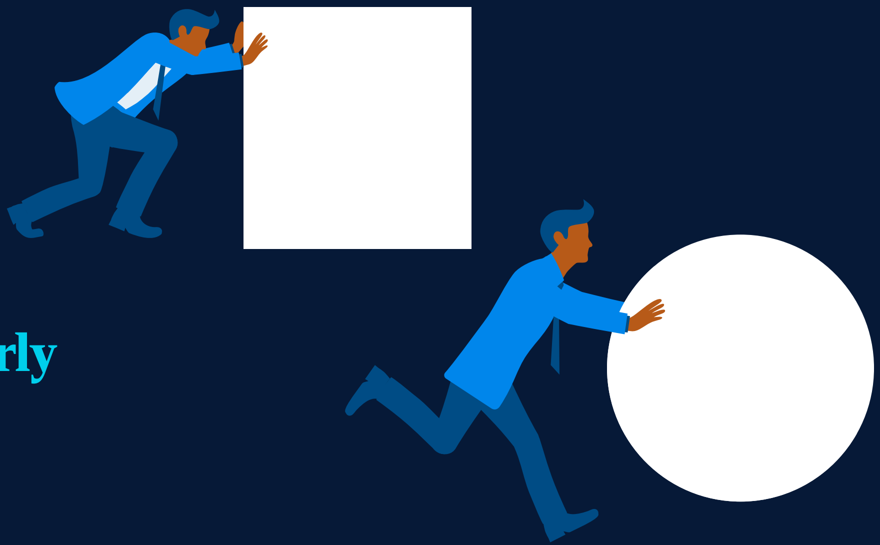
T. Rowe Price



Capital Appreciation Equity ETF (TCAF): Exploiting market inefficiencies and the early success of an active ETF

June 2024

Key Insights

- Celebrating one year in June, TCAF hit $1.6 billion in net assets, showcasing the early success of this active management strategy.
- By avoiding companies with poor management or poor capital allocation, TCAF seeks to enhance portfolio performance.
- David Giroux and his team favor companies in areas such as health care and utilities for their defensive qualities against a backdrop of uncertainty in markets.

How do you make an S&P 500 Index-focused exchange-traded fund (ETF) significantly better? As Portfolio Manager David Giroux explains, he believes the answer is active management.

Giroux manages the recently launched Capital Appreciation Equity ETF (ticker: TCAF), which just celebrated its one-year anniversary on June 14, 2024. Although the ETF is still new, it shares a common investment philosophy with the long-established Capital Appreciation Fund, which Giroux also manages. The ETF has enjoyed significant popularity, with $1.6 billion in net assets as of June 7, 2024.

Giroux explains the thinking behind combining the benefits of an ETF with T. Rowe Price's signature skill in active management. "We wanted to create a product we thought was clearly superior to an S&P 500 Index fund or ETF," he explains. To do that, he outlined three specific goals for TCAF:

- Outperform the market on a consistent, yearly basis
- Manage the portfolio to be less risky than the market
- Offer more tax efficiency than an S&P 500 Index strategy

A peek inside the strategy

How does Giroux expect to deliver these benefits consistently while still keeping ETF costs low? He points to a systematic approach to active management. He and his team have identified company characteristics that they associate with stock underperformance, and identified every stock in the S&P 500 that exhibits one of six "fatal flaws," including poor capital allocation and poor management teams. It turns out, there are a lot of them—as many as 375 of the total 500. By excluding these companies, the team can build a portfolio of around 95 to 105 stocks that they believe will have the potential for outperformance.

"We can create a lot of alpha (that is, outperformance of the benchmark) simply by avoiding those companies," says Giroux, while S&P 500 Index investors have no choice but to keep them in their portfolio. Another TCAF advantage—thoughtful risk management. In Giroux's view, there's a lot of downside risk in leaving your portfolio on autopilot.

In terms of market positioning, equities are currently expensive due in part to an AI-led rally. And Giroux recognizes that a heightened appetite for risk has resulted in high-beta (risk) stocks within the S&P 500 significantly outperforming their lower-risk counterparts. TCAF, structured to be 3% to 6% lower in beta than the broader market, did not thrive in such an environment. However, he remains confident that as the market shifts back to valuing corporate fundamentals, our long-standing investment philosophy will have the potential to yield favorable results. Although contrarian investing is challenging, Giroux believes that maintaining a long-term perspective rather than chasing immediate gains allows the fund to exploit market inefficiencies and create shareholder value.

Watch the discussion to learn more about the TCAF strategy as well as Giroux's views on key market topics, such as:

- **Artificial intelligence**
- **GLP-1 weight loss drugs**
- The importance of capital allocation as a determinant of quality businesses

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ETFs are bought and sold at market prices, not NAV. Investors generally incur the cost of the spread between the prices at which shares are bought and sold. Buying and selling shares may result in brokerage commissions which will reduce returns.

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